DOW THEORY LETTERS INC.

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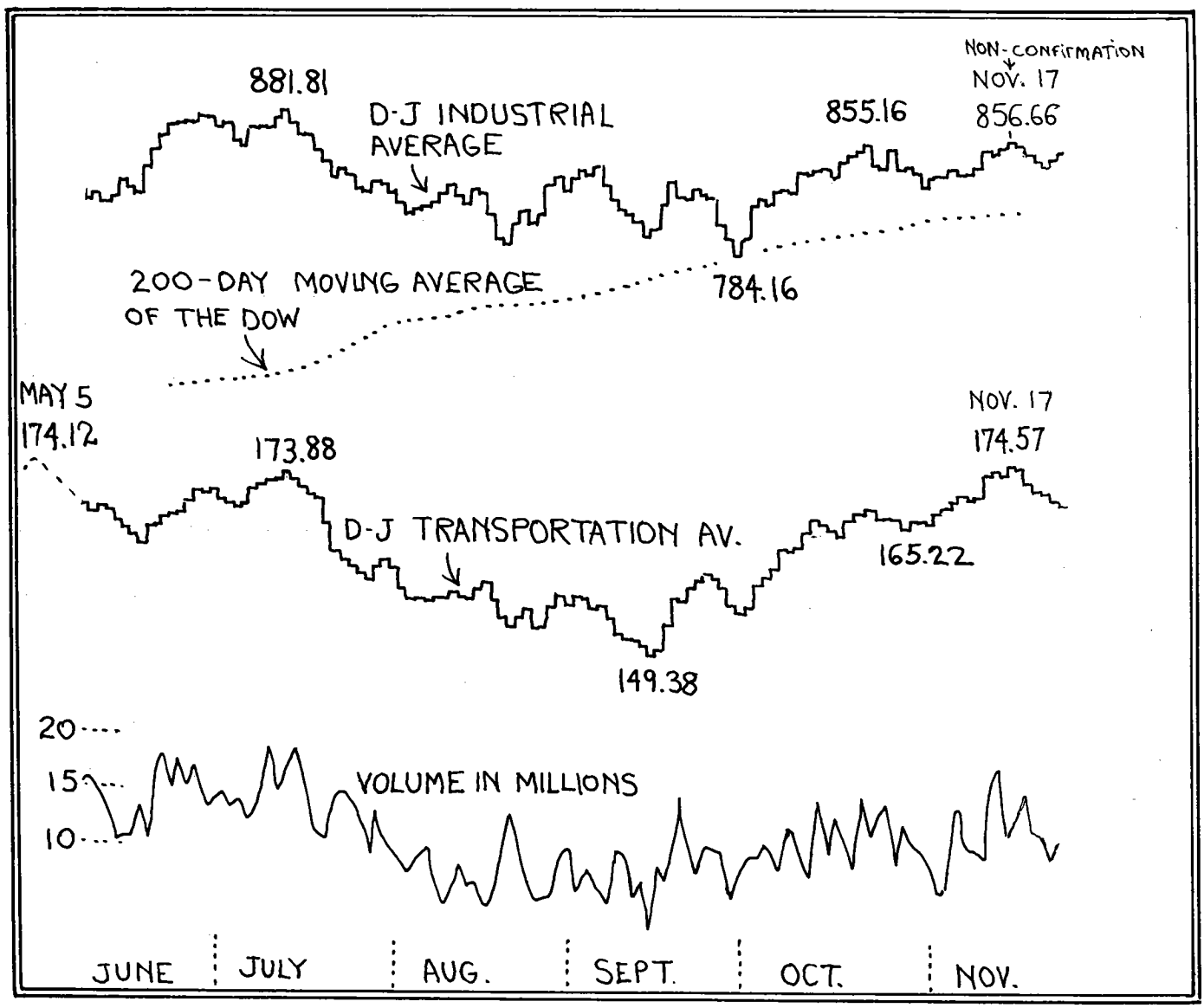
Special Warning Letter

DOW'S THEORY AND THE ADORNMENTS: Charles Dow wrote a great deal about stocks and values, and he commented that over any extended period of time stocks swing from areas of overvaluation to undervaluation and back to overvaluation again. Dow talked about bull and bear markets, and the fact that men (and the economy) go through cycles of depression to enthusiasm and back to depression again. Actually, Dow wrote very little about the Averages and he never mentioned the confirmation principle. Nevertheless, the Dow Theory was named in honor of Dow's original observations about values, markets and the economy.

William Hamilton (third editor of the Wall Street Journal) and Dow's protegé was the man who first noted that the Dow Jones Industrial and Rail Averages must confirm each other by penetrating preceding levels if the movement is to be accepted as valid. Hamilton was a master "reader" of the market, and many of his predictions were undoubtedly based on his own intuition or on indices which he did not actually write about. Nevertheless, Hamilton's reasoned and often brilliant market pieces appearing in Barron's and the Wall Street Journal enjoyed a wide following from the years 1903 to 1929 (Hamilton died in late-1929).



Robert Rhea, a brilliant student of both Dow and Hamilton, began publishing his famous Dow Theory Comment in 1932. His first feat was calling the bottom (within a week) of the greatest market collapse in American history. Rhea codified and refined the methods of Dow and more specifically Hamilton and added many techniques and observations of his own. Rhea was basically a pure Dow Theorist in that he wrote mainly about the price movement along with volume indications. Nevertheless, Rhea (as did Dow and Hamilton) frequently discussed the economy and the prevailing psychology of the time.

Of all the market writers, I have found Rhea to be the most brilliant and the most successful. Rhea was dealing with a very difficult period following the great crash and the succeeding 1932-37 bull market, and I still learn a great deal from re-reading Rhea's works as he struggled with the markets of his time.

Even Rhea had trouble with the complex period of 1938 and 1939, and I believe that coping with those last two years in the market may have contributed to his early death. The short, choppy markets of '38 and '39 were two of the worst (for analysts) that I have ever seen, and it is perhaps no coincidence that from the period of 1939 to 1948 no Dow Theory writing of note appeared in a national publication not did any Dow Theory service exist.

E. George Schaefer began his "Dow Theory Trader" service in 1948, and this brilliant man added many new concepts and refinements to his basic Dow Theory interpretations. Schaefer incorporated odd-lot studies, short interest studies, moving averages, yield cycles, and in all turned out an outstanding publication which gathered a wide following from the early 1950's until his untimely death in 1974. Schaefer made an incredible call (within a week) of the bear market bottom in June, 1949, and he also accurately called the bull market top in 1966. I believe his name will be included with Dow, Hamilton and Rhea as a pioneer-genius in stock market studies.

Today, we have a most interesting and in many ways unique situation. There are presently around 30 million stockholders in the nation. Admittedly, a small fraction of that 30 million read or seriously follow the markets, but nevertheless the level of Wall Street sophistication is now at its highest in history. For instance, when I started Dow Theory Letters in 1958 it was considered heresy for a bank analyst or a portfolio manager to even give credence to the "technical approach" to the market. Analysts who subscribed to this service usually had it mailed to their homes, for the obvious reason that they did not want their cohorts to know that they were reading "a technician."

All that has changed, and the Dow Theorist and the technician are now accorded some respect or at worst they are listened to and read openly rather than under the table. But my own feeling is that in many ways the technicians have overdone a good thing, not because they really wanted to — but because it has seemed like "an easy entrance" to Wall Street and the world of the stock market. After all, it does require some amount of brains to produce a readable report on Xerox, but any damn fool can plot some lines on a chart and claim he's found a new technical method for beating the market.

The proof of what I say is probably in the statistics. There aren't many of us technicians with market services left these days. If it's so easy, you may ask, then why are there only about four or five technical services (with a wide following) currently in business? The answer is that technically or fundamentally, Wall Street is a very tough place to be. During the great bull market of the 1950's and '60's, services were a dime a dozen. Barron's pages carried advertisements of a new arrival each week. But the years 1966 to '74 acted as a giant "meat grinder" for Wall Street and the advisory business, so now I find myself with just a few writing buddies left, men such as Dines, Gould, Schultz, Granville.

DOW THEORY: According to Dow Theory, the Averages contain the sum total of everything that anybody knows about stocks and corporate matters, sifted, clarified and brought down to buy and sell orders. That mass of hard-money opinion is reflected hourly and daily in the movement of the stock Average. "But what about all the technical factors?" you ask. "What about the debit loans, the odd lot shorts, the margin accounts, the fund liquidity ratios?" And my answer is that according to classic Dow Theory, all of those indicators and hundreds of others are built into the price structure of the Averages.

"Oh, really," you counter, "then why do you bother discussing such things as the advance-decline ratio, the moving averages, momentum and so forth?" And my rather plaintiff answer is that if I was as good as I would like to be at reading the price movements, I wouldn't need any "outside help" at all. You could lock me in a room, show me the daily closings of the D-J Industrials and Transports with volume, and I would be able to come out with brilliant conclusions.

But unfortunately, I'm not that good. I'm not that much of a genius. So I need all the help I can get, and many of the various indicators provide just such help. But, and this is a note of warning, the art of reading the market often entails knowing which indicators to believe and which indicators to throw out at any given time. And, of course, that's just another way of saying that there never has been a method, an index or a technique for consistently beating the market. There are only tools to aid us in increasing the odds.

PRICE MOVEMENT AND THE DANGER OF A "DOUBLE NON-CONFIRMATION IN THE AVERAGES: I am mailing this Letter five days ahead of schedule because I want to draw attention to a potentially dangerous pattern in the price structure. I prefaced this report with a Dow Theory discussion in order to give newer subscribers some idea of the history of Dow Theory and the study of the price movement. I also want them to understand that there is nothing perfect about the study of the price movement, and there is certainly nothing infallible about this market student. Nevertheless, I do wish to draw subscribers'

attentions to a new development which (in my experience) could bring about a strong reversal of the upward trend.

Veteran subscribers may remember some of my previous studies of the "double non-confirmation." This is the most powerful reversal structure which can appear in the Averages. The double non-confirmation occurs when first one, then the other Average produces a non-confirmation. This structure implies that first one, then the other Average is weak. Such structures can be followed by extended and often violent movements in the opposite direction from which they were going.

Referring to the chart on page 1, note that following the rise from the September-October lows, the two Averages struck peaks on November 17. The D-J Transportation Average recorded a new 1975 recovery high of 174.57 on that day, a figure which was fractionally above the old May 5 peak of 174.12. Industrials, however, halted their rise at 856.66. In other words, Industrials did not confirm the new Transport high. This constituted the first non-confirmation.

From the November 17 peaks, a four-day decline took place, following which the market rallied into the Thanksgiving holiday. But note that whereas Industrials during the preceding period were the weaker Average in that they did not confirm the new Transport high, the Transports (after November 17) appeared to be turning weak. As this is written (November 25) the carriers are resisting what could easily be an Industrial bettering of their preceding 856.66 peak (Transports would have to better 174.57 in order to confirm).

This Letter is necessarily being written before the event so that I am only guessing at what might happen, and I am drawing attention to the danger IF Transports refuse to confirm. If the Industrial Average hurdles the 856.66 level and Transports persistently refuse to confirm (i.e., refuse to better 174.57), then I would consider the situation to be highly dangerous. At that time a double non-confirmation would exist in the Averages with first Industrials being weak, then Transports being weak.

Question: If we get the double non-confirmation and the market turns down, what course of action would you suggest?
Answer: I would suggest moving out of all common stocks and into a position of high liquidity.

Question: But suppose the New York City mess is settled at the time of a double non-confirmation? Wouldn't that be a bullish development?
Answer: For the economy, maybe, I really don't know, and it is not my job to render an expert opinion. But a NYC "bailout" or what-have-you might well provide the finishing touches on this rise in that the market would use the news to distribute.

Question: Suppose Industrials go above 856.66, Transports don't confirm, and then in due time the Transports push up and do confirm?
Answer: That could happen, but I don't like the way Transports have suddenly turned weak, following their powerful performance since the September low. Why should the Transports, after leading the market up for two months, suddenly fade out and fail to confirm?

Question: If Industrials are strong enough to rally above 856.66, couldn't they carry the whole market with them?
Answer: Perhaps, but remember, Industrials did not, on November 17, rally to a new 1975 recovery high so that they were the weaker Average to begin with. If Transports now turn weak (and a Transport non-confirmation would show them to be weak), then we would have two weak Averages. The fact that Industrials failed on November 17 to advance to a 1975 high (whereas Transports did) hardly suggests that the Industrial Average alone is going to lead the market up from here.

Question: What would make you "feel better" about the whole technical situation?
Answer: I'd feel better if both Averages pushed strongly above their November 17 highs of 856.66 and 174.57 respectively on increasing volume!

Question: If the double non-confirmation materializes and the market turns down, could this be the beginning (or a resumption of) the 1966-74 bear market?
Answer: Possibly, but I doubt it strongly. As long as the 1974 lows hold, the primary trend will be bullish. But although that is a long-term consolation for businessmen and investors, a smash by the Dow to say 650 would hardly be something I would want to ride out (the 1974 lows were 577.60 for Industrials, 125.93 for Transports).

Question: If the market goes South, wouldn't golds be a good trading vehicle?
Answer: Perhaps. Bullion momentum turned sluggishly up (reversed to the upside) last week, and this could be a harbinger of a turn up for gold shares. I don't advocate trading for most subscribers, but for those who want to trade, Amgold and Homestake would be my trading choices. ASA and Homestake could have double bottoms at this time and that would allow for at least countertrend rallies. But I am not a gold bull yet; I'm just talking this way for the benefit of those who are foaming at the mouth to own gold shares again. In brief, IF the market goes down, golds could be an interesting trading vehicle here.

Question: How can you be bullish for months and then suddenly send out a warning reports of this kind?
Answer: I guess I feel that I know more this week than last. Second, I know that the market can do anything, and I have learned never to argue with it. I write what I see, not what I want to see. Right now I would love to see blue skies and Roman candles for Wall Street. Instead, I see the potential for a double non-confirmation (although, of course, I hope it doesn't materialize).

Question: Somehow, I sense that you see or feel something. Maybe I'm dense, but I can't seem to put my own finger on it. Could you state again what bothers you about this whole market situation?
Answer: I'll try to explain it this way: I've been saying for weeks that "the strength of this market" is the Transportation Average. If Industrials rise above 856. 66 and Transports fail to confirm, then the strength of the market will have turned weak. That would be like pulling half the bricks out of the foundation of a house.

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In conclusion, let me ask all of my readers to please set your emotions aside. Act in the market from your head, not your heart. Remember, you may be interested in Wall Street but (unfortunately) Wall Street could not care less about you.

Next mailing: December 12th.